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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1476

J. W. BATESON COMPANY, INC., et al., *Petitioners*

v.

UNITED STATES OF AMERICA FOR AND ON BEHALF OF THE BOARD OF TRUSTEES OF THE NATIONAL AUTOMATIC SPRINKLER INDUSTRY PENSION FUND, et al., *Respondents*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF OF THE SURETY ASSOCIATION OF AMERICA AND THE AMERICAN INSURANCE ASSOCIATION AS AMICI CURIAE

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INTEREST OF AMICI CURIAE [1]

The Surety Association of America (SAA) is a non-profit unincorporated trade association organized in 1908. It has 431 member companies, most of which are engaged in the business of suretyship. Among its activities, SAA makes filings with regulatory authorities, secures statistical data, prepares forms of coverage for use by its members, and on appropriate occasions represents its members' interest in suretyship issues of national concern.

The American Insurance Association (AIA) is a non-profit unincorporated trade association organized in 1965. It is the successor through merger of the National Board of Fire Underwriters (established in 1866) and the Association of Casualty and Surety Companies (established in 1927). It has 147 member companies, most of which are engaged in the suretyship business. Among its activities, AIA digests all statutes and cases affecting suretyship and appears before legislative bodies and administrative agencies on behalf of its members.

The members of the SAA and AIA constitute a majority of the surety companies in the United States. As sureties, they underwrite the great majority of payment bonds issued under the Miller Act [2] for prime contractors on construction projects of the Govern-

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[1] This brief is filed pursuant to Supreme Court Rule 42(2) with the consent of all parties. Letters of consent from the parties have been filed with the Clerk of the Court simultaneously with this brief.

[2] 40 U.S.C. § 270a *et seq.*

ment. The scope of the coverage provided by those bonds, and thus the scope of the companies' liability exposure thereunder, is defined by the Act and the courts' interpretation thereof. Accordingly, the member companies of SAA and AIA will be directly affected by the Court's decision in this case.

SUMMARY OF ARGUMENT

The Miller Act was intended to balance the needs of laborers and materialmen for financial protection against the sureties' need to reasonably measure the risks they would be asked to assume. This balance was achieved by requiring prime contractors to obtain payment surety bonds but limiting the coverage of those bonds to parties in privity of contract with either the prime contractor or its direct subcontractors. The opinion of the lower court in this case disrupts this essential balance by extending Miller Act payment bond coverage to claimants far removed from the contractual relations of the prime contractor and its subcontractors. In doing so, the lower court disregarded the language of the Miller Act and its legislative history, and it contravened this Court's prior holdings in *F. D. Rich Co.* v. *United States ex rel. Industrial Lumber Co.*, 417 U.S. 116 (1974) and *Clifford F. MacEvoy Co.* v. *United States ex rel. Calvin Tomkins Co.*, 322 U.S. 102 (1944).

The decision of the lower court, if allowed to stand, will expose prime contractors and their sureties on projects already underway to vastly increased risks that were never anticipated at the time the contracts were undertaken. The amount of risk which a surety can reasonably assume is a function of the contractor's

financial strength. The ultimate consequence of the expansion of risk resulting from the lower court decision will be that fewer contractors will have the requisite financial strength to qualify for bonds in the future and the amount of the bonds for which they can qualify will be smaller. This will restrict future Government projects to the larger and better financed contractors who are able to demonstrate their ability to indemnify sureties against the greatly increased risk of exposure to downstream claims.

ARGUMENT

I. The Decision of the Court Below Is Contrary to the Language of the Miller Act, Its Legislative History, and the Prior Decisions of This Court.

The decision of the lower court in this case is contrary to both the prior decisions of this Court and the plain language of the Miller Act. To understand the error of the lower court's decision and the significant impact it will have upon the surety industry and Government construction, one must appreciate what Congress was attempting to do when it enacted the Miller Act.

With passage of the Miller Act, Congress was attempting to strike a balance. Congress wished to provide a private surety guarantee of payment to those persons supplying labor and materials on federal construction projects in order to compensate for the lack of mechanic lien rights against the Government. At the same time, Congress recognized that such guarantees would be feasible only if the private sureties could reasonably measure the risk they would be asked to assume.

The difficulty of risk measurement lay in the fact that on large construction projects involving many different trades and materials, significant parts of the work could be delegated down through many levels of subcontractors, sub-subcontractors, material suppliers to sub-subcontractors, etc. For example, in the case of a contract to construct an army base consisting of several buildings and connecting roads, the prime contractor, being principally a building contractor, might subcontract out all road work to a road contractor, who might, in turn, subcontract the asphalt paving portion of the road work (as opposed to the grading and sub base portions) to a paving contractor. The paving contractor might, in turn, relet half of its work to a smaller firm. Half of the paving would thus be done by employees of a firm several tiers removed from the prime contractor. In such a case, a guarantee of payment to the employees who actually performed the sub-sub-subcontracted paving work would require a guarantee that (1) the prime will pay the road contractor, (2) the road contractor will pay the paver, (3) the paver will pay the smaller firm, and (4) the smaller firm will pay its employees.

Congress, in passing the Miller Act, recognized that no surety could reasonably be expected to measure, and thus undertake, a risk which was so extended and so dependent upon the financial soundness and integrity of companies, e.g., the sub-sub-subcontractor, whose identity normally is not even known when the bond is issued. Congress, therefore, recognized that the reach of the payment bond had to be limited. It did this by including in the Miller Act the proviso in § 270b(a). This proviso was totally ignored by the lower court in this case.

The proviso in § 270b(a) defines the limits of the surety's payment guarantees (or, conversely, the rights of claimants) in terms of privity of contract. To recover on a Miller Act payment bond, the claimant must have had a contractual relationship with either the prime contractor or one of the prime's direct subcontractors. As this Court stated in *Clifford F. MacEvoy Co.* v. *United States ex rel. Calvin Tomkins Co.*, 322 U.S. 102, 107 (1944):

> The proviso of [§ 270b(a)] . . . makes clear that the right to bring suit on a payment bond is limited to (1) those materialmen, laborers and subcontractors who deal directly with the prime contractor and (2) those materialmen, laborers and sub-subcontractors who, lacking express or implied contractual relationship with the prime contractor, have direct contractual relationship with a subcontractor . . . .

This limitation goes to the very heart of the suretyship undertaking. Suretyship is not insurance. It is a guarantee of the principal's financial ability, integrity, and commitment to live up to its contract obligations, akin to a guarantee of a bank loan. The surety's issuance of a bond is based upon its investigation and evaluation, much like a bank credit evaluation, of the principal's financial strength and record of performance. Under the Miller Act, the surety's payment bond, on its face, goes, with one minor exception, only to the prime contractor's obligations to pay those with whom it has directly subcontracted or directly purchased materials. The only exception is that the bond also guarantees payment of a claimant who has a "direct contractual relationship with a subcontractor" and has satisfied certain notice requirements.

This statutory limitation of bond coverage is neither arbitrary nor hypertechnical. It is a common-sense policy based upon the nature of the suretyship relation (a guarantee that the principal will fulfill its contract obligations) and the practical reality that most Government construction contracts involve performance of work at multiple tiers (e.g., prime contractor, subcontractor, sub-subcontractor, etc.). The rationale underpinning the statutory limitation is particularly well illustrated by the instant case. In this case, the surety was properly expected to guarantee payment at the first tier, i.e., that the prime contractor, for whom the bond was issued on the strength of its financial and past performance record, would pay its direct subcontractors and direct material suppliers. The prime contractor in this case, J. W. Bateson Co., fulfilled that payment obligation. Congress also determined that it was reasonable for the surety to guarantee that the prime's direct subcontractors would pay those with whom they had a direct contract relationship, i.e., that payment would be made at the second tier. This is a reasonable burden because the prime contractor selects its direct subcontractors and can avoid doing business with a subcontractor that is weak financially or has a poor reputation for paying its debts. The prime contractor can also include in its subcontract such terms as are needed to minimize or protect against any failure of its subcontractors to pay those from whom they obtain labor or materials. In this case, that was no problem since Bateson's direct subcontractor, Pierce Associates, did, in fact, pay all of its contract obligations.

The only non-payment in this case occurred at a lower level when Colquitt, a sub-subcontractor that

had no contract with Bateson, failed to pay its employees' union welfare benefits. J. W. Bateson Co.'s surety in this case cannot reasonably be expected to guarantee that a company, such as Colquitt, which Bateson did not select and as to whom Bateson had no contract rights, would pay its contract obligations. Before issuing the bond, a surety can satisfy itself within reasonable limits that the prime contractor for whom the bond is issued can and will pay its debts and that it will choose only direct subcontractors who will do the same. However, the surety cannot be expected to go further and guarantee the financial ability and integrity of remote sub-subcontractors about whom it knew nothing when it issued the bond and over whom the prime had no power of selection or control.

The necessity of the statutory limitation is confirmed by the legislative history of the Miller Act, as well as this Court's decisions in *F. D. Rich Co.* v. *United States ex rel. Industrial Lumber Co.*, 417 U.S. 116 (1974), and *MacEvoy Co., supra.* In explaining why the right to sue on a Miller Act bond was being limited to those with a direct contract relationship with either the prime contractor or one of its direct subcontractors, the House Report on the Miller Act stated, "A sub-subcontractor may avail himself of the protection of the bond by giving written notice to the contractor, but that is as far as the bill goes. It is not felt that more remote relationships ought to come within the purview of the bond." H.R.Rep. No. 1263, 74th Cong., 1st Sess. at 3. To extend the Act's coverage to employees of a sub-subcontractor or, as here, to a union welfare fund making a claim against a sub-subcontractor goes that extra step which Congress clearly chose not to take.

In *MacEvoy*, this Court explicitly recognized that Congressional intent when it quoted the foregoing statement from the House Report and then added: "To allow those in more remote relationships to recover on the bond would be contrary to the clear language of the proviso and to the expressed will of the framers of the Act." 322 U.S. at 108. The Court went on in *MacEvoy* to explain why the bond's protection stops with those who have a direct contract relationship with a direct subcontractor of the prime contractor:

> Practical considerations underlying the Act likewise support this conclusion. Congress cannot be presumed, in the absence of express statutory language, to have intended to impose liability on the payment bond in situations where it is difficult or impossible for the prime contractor to protect himself. The relatively few subcontractors who perform part of the original contract represent in a sense the prime contractor and are well known to him. It is easy for the prime contractor to secure himself against loss by requiring the subcontractors to give security by bond, or otherwise, for the payment of those who contract directly with the subcontractors. *United States* v. *American Surety Co., supra,* 204; *Mankin* v. *United States, supra,* 540. But this method of protection is generally inadequate to cope with remote and undeterminable liabilities incurred by an ordinary materialman, who may be a manufacturer, a wholesaler or a retailer. 322 U.S. at 110.

In *MacEvoy*, the Court was dealing with claimants who supplied materials to a materialman. However, the Court's holding as to the Act's application and its rationale as to remoteness apply equally, if not more

so, to the instant claim of a union welfare fund representing employees of a third tier sub-subcontractor.

This Court's decision in *F.D. Rich Co.* is not to the contrary. The lower court's decision in this case misapplied *Rich* by taking this Court's comments completely out of context. In *Rich,* the claimant had supplied materials to Cerpac, a subsidiary of the prime contractor. Cerpac had two separate contracts with the prime—one a direct subcontract to install millwork and the second a materials contract to supply the lumber. The issue in *Rich* was whether the claimant was a supplier of a materialman (under Cerpac's material contract), not covered by the Act, or a supplier of a subcontractor (under Cerpac's installation subcontract), covered by the Act. This Court held that under those facts substance prevailed over form and Cerpac's two contracts (one for labor, the second for materials) would be considered as one, making it a subcontractor. There was no question in *Rich* that Cerpac had a direct contract relationship with the prime contractor and, indeed, was an *alter ego* of the prime in the true sense. That is not the situation here.

The "substantial relationship" test was used in *Rich* only to determine whether a subsidiary, which had a direct contract with the prime, was a first-tier subcontractor or a first-tier materialman. It was not used by this Court, as it now is being used by the lower court, to "jump a tier" and transform a sub-subcontractor, with no contract relationship at all with the prime, into a direct subcontractor with such a relationship. Indeed, in *Rich* the Court indicated that this tier distinction between a direct subcontractor and a sub-subcontractor could not be so blithely erased

when it referred with apparent approval to its earlier definition, in *MacEvoy,* of a subcontractor as "one who performs for and *takes from the prime contractor* a specific part of the labor or material requirements of the original contract." 417 U.S. at 123 (Emphasis added). The sub-subcontractor, Colquitt, did not take any work from the prime contractor in this case. The prime contractor subcontracted that work to Pierce. Colquitt took its work from and was performing for Pierce, the subcontractor, not Bateson, the prime contractor. Under the *MacEvoy-Rich* definition, therefore, Colquitt is not a subcontractor and the lower court's decision to that effect is in error.

The lower court in this case did not merely misapply a test previously adopted by this Court for determining the Miller Act's coverage; it went much further and totally discarded the "contractual relationship" test of the statute and substituted in its stead a new test whereby a sub-subcontractor becomes a direct subcontractor whenever its services are "substantial and important." The extent of this disregard for the language of the statute and the prior decisions of this Court is illustrated in the lower court's concurring opinion, which states:

> Whether the labor and materials are furnished directly to the prime contractor or through a subcontractor or a sub-subcontractor is irrelevant as far as the protection provided by the Act is concerned.[1]

This statement that a contractual relationship with the prime contractor or a subcontractor is "irrelevant" under the Miller Act flies in the face of both the statu-

[1] 551 F.2d 1287.

tory language and this Court's holding in *F. D. Rich, Inc.* that:

> The rights afforded by the Act are limited, however, by the proviso of § 270b(a). In *MacEvoy Co.* v. *United States ex rel. Tomkins Co., supra,* this Court construed § 270b(a) to limit the protection of a Miller Act bond to those who had *a contractual agreement* with the prime contractor or with a "subcontractor." 417 U.S. at 122 (emphasis added).

There is no basis in fact or law for conferring subcontractor status on the sub-subcontractor in the present case, since there was no privity of contract with the prime contractor.

II. The Decision of the Court Below Will Disrupt the Surety Bond Marketplace and Impair the Capacity of Contractors to Undertake Government Contracts.

The lower court's error in this case is not an academic one. There are billions of dollars in Government contracts in progress that will be affected by the present case. If allowed to stand, the lower court's decision will have a substantial impact on every Government construction project, both present and prospective, since it materially expands the payment bond risk by imposing on the prime contractor and the surety virtually unlimited responsibility for the payment of debts by others with whom they have no contract relationship and over whom they have no meaningful control. The man who digs the coal to make the steel is just as "substantial and important" to the prosecution of the work as the man who installs the product in the project. Yet the prime construction contractor and its surety cannot reasonably be expected to guarantee that this miner will be paid by the mine owner. Where do

you draw the line? Virtually every act of providing service or materials is "substantial and important" if acceptance of the contract work cannot be had without it.

Economic realities are such that this risk exposure cannot be ignored by a surety. To compensate for the substantially greater exposure, sureties necessarily will have to become more selective in the issuance of bonds. The greater the exposure is, the greater the prime contractor's financial strength must be before a bond can be issued consistently with sound underwriting practices. The present decision, therefore, unless corrected, will ultimately cause a substantial dislocation in the market place by restricting the number of contractors that can qualify for bonds and by restricting the amount of the bonds for which even the successful contractors may qualify.

That such will be the ultimate practical consequence of the present decision follows from the special nature of the suretyship relation. As indicated above, suretyship is a specialized transaction which is underwritten only upon the credit worthiness, performance record, and financial strength of the principal and its promise to indemnify and hold the surety harmless from all loss, costs, and expenses of whatever kind and however arising under the bond. The fee the surety receives, which is paid only once, is small, starting at 1% of the contract amount for contracts up to $1,000,000 and declining to about ½% for contracts over $2,500,000. The fee is not an actuarial computation of the risk. It is a charge to cover management's expense of prequalifying the contractor[*] and to provide a profit, if

[*] *I.e.*, determining the contractor's capacity to perform the work and pay accounts for labor and materials.

there is no loss. Unlike in the insurance industry, the surety's real protection against bond losses lies not in the bond fee but in the principal's promise to hold the surety harmless from any loss and in the principal's financial ability to keep that promise. The principal's indemnity, coupled with the personal indemnity of the owners of the business, which is also usually required as a condition to underwriting the bonds, is the heart of the principal-surety relationship. The ultimate protection of the surety is, therefore, the financial capacity of its principal and indemnitors to pay claims that arise under the bonds.

Prior to the present decision, sureties would normally issue a Miller Act bond in an amount up to 10 times "net quick" assets[5] (or higher) of those principals having a good record on contracts of a similar nature. Thus, a well regarded contractor with a net quick of $1,000,000 could certainly obtain bonds up to $10,000,000. Contractors with a less favorable experience or higher risk exposure would be written, if at all, at much lower multiples, such as 5 times net quick. The greater the risk involved, the lower the multiple becomes, and the amount of bond coverage a particular contractor can obtain is reduced accordingly.

Under the lower court's decision, the risk under a Miller Act payment bond would become considerably greater than it was under prior decisions since there then would be a new bond liability for a sub-subcontractor's failure to pay its employees for certain work even though the prime has paid its subcontractor for the work and that subcontractor has paid the sub-subcontractor. In the event of such a payment default by the

[5] *I.e.*, net current assets.

sub-subcontractor, the prime contractor would be forced to pay twice for the same work, or if it is financially unable to do so, the surety would be compelled to pay a third-tier claim that, until now, was not considered covered by the bond. Thus, an entirely new level of risk would be added to Miller Act payment bonds.

Sureties will be unable to underwrite this expanded risk except at considerably lower multiples of net quick than before. Since most contractors will be unable to materially increase their net quick, this will restrict substantially the contractor's bonding capacity. The reduction in bonding capacity will (i) limit the contractor's ability to take on new work for the Government and (ii) confine it to smaller contracts than previously.

These are the consequences of an increased risk, since suretyship is grounded on principles of indemnity and the fee charged for acting as surety is not an actuarial computation of the risk. Indeed, suretyship defies actuarial rating in the insurance sense, since every construction project differs.

A San Francisco Bay bridge, a Hoover dam, a new addition to the Library of Congress all pose different risks. If a dozen San Francisco Bay bridges were to be built, for example, on the identical site at about the same time by different contractors, credible statistics would emerge which could be used to establish a realistic single premium rate for the risk of building more San Francisco Bay bridges at that site without the need for indemnity. This, then, would be insurance. Since it is impossible to obtain credible loss experience through repetitive construction of each project, suretyship underwriting is premised on the indemnity re-

sources of the contractor and its indemnitors. To do otherwise would require guessing at a single premium rate for each construction project and, out of caution, that rate would probably be excessively high—so much so as to add very materially to the cost of the work.

To the extent that increased losses resulting from the present case are not recovered from indemnitors, they must be paid by the surety from its own capital resources. This will affect sureties in their willingness to underwrite Federal Government construction contracts.

The Court of Appeals opinion suggests that a contractor can protect itself by requiring downstream bonds. However, that solution is neither practical nor necessarily in the public interest. Given the time constraints within which the work must be performed and the size of the projects, an array of parties become involved, with hundreds and even thousands of purchase orders, subcontracts, sub-subcontracts, etc., on down the line. Most, if not all, of these parties are "substantial and important" in the context of providing labor or materials essential to aceptance of the work.

Setting aside questions of the impracticality of full "downstream" bonding and public policy considerations over restrictive provisions that would have to be incorporated in every contract to accomplish the desired downstream protection, other concerns emerge. It is to be anticipated that complete subcontractor downstream bonding will necessarily restrict the market to the larger subcontractors that can get bonding. As a consequence, entry into the market by smaller subcontractors will be discouraged, competition will be narrowed, and this suggests that contract prices for work will rise.

Also, unless the present case is reversed, the courts will doubtlessly be confronted with the argument that, notwithstanding this Court's holding in *MacEvoy*, pure material suppliers are also subcontractors because they are "substantial and important" to the work. If that should emerge as a legal reality, then the restrictiveness of a requirement for full downstream bonding to protect the prime contractor will reshape the material supply business in the United States. The exposure from downstream claims will be of such magnitude that the bonding capacity (net quick) of the material suppliers will be a prime consideration in making purchases, with price and availability of materials a lesser consideration. Eventually, only the giants in the materials industry will have the capacity to furnish bonds to prime contractors for the billions of dollars of material purchased annually to perform Government construction contracts.

It is well understood that liberal construction is to be given to the Miller Act. But liberality of construction is not meant to go so far as to extend the scope of the Act. As this Court stated in *MacEvoy:*

> The Miller Act, like the Heard Act, is highly remedial in nature. It is entitled to a liberal construction and application in order properly to effectuate the Congressional intent to protect those whose labor and materials go into public projects. *Fleisher Engineering Co.* v. *United States,* 311 U.S. 15, 17, 18; cf. *United States* v. *Irwin,* 316 U.S. 23, 29, 30. But such a salutary policy does not justify ignoring plain words of limitation and imposing wholesale liability on payment bonds. . . . [W]e cannot disregard the limitations on liability which Congress intended to impose and did impose in the proviso of [§ 270b(a)]. 322 U.S. at 107.

The Court in that case went on to conclude with an observation that is equally applicable to the present case:

> To impose unlimited liability under the payment bond to those sub-materialmen and laborers is to create a precarious and perilous risk on the prime contractor and his surety. To sanction such a risk requires clear language in the statute and in the bond so as to leave no alternative. Here the proviso of [§ 270b(a)] of the Act forbids the imposition of such a risk . . . . 322 U.S. at 111.

CONCLUSION

We shall not recite the long line of authority in contradiction of the present case. They appear in other briefs. The policy of Congress to restrict the scope of the Act to those in privity of contract with the prime contractor and its subcontractors is evident and clear from the statute itself. Therefore, the Court is urged to reverse the lower court's decision in the present case.

Respectfully submitted,

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